

DETERMINING PROBABLE AND REASONABLY ESTIMABLE

FOR

ENVIRONMENTAL LIABILITIES IN THE

FEDERAL GOVERNMENT

FEDERAL FINANCIAL ACCOUNTING AND AUDITING

TECHNICAL RELEASE NUMBER 2

The Accounting and Auditing Policy Committee (AAPC) was organized in May 1997 by the Office of Management and Budget (OMB), the General Accounting Office (GAO), Treasury, the Chief Financial Officers' Council (CFO), and the President's Council on Integrity and Efficiency (PCIE), as a new body to research accounting and auditing issues requiring guidance.

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The mission of the AAPC is to assist the Federal government in improving financial reporting through the timely identification, discussion, and recommendation of solutions to accounting and auditing issues within the framework of existing authoritative literature.

INTRODUCTION

Federal agencies are required to recognize a liability when a future outflow or other sacrifice of resources as a result of past transactions or events is "probable" and "reasonably estimable." This technical release is intended to assist federal agencies in determining probable and reasonably estimable liabilities related to their environmental cleanup responsibilities.

Agencies that must deal with environmental contamination should first refer to the hierarchy of accounting standards contained in the current Office of Management and Budget (OMB) Bulletin on "Form and Content of Agency Financial Statements" for guidance. Standards issued by General Accounting Office (GAO) and OMB have precedence over other authoritative guidance for federal entities. This technical release supplements the relevant federal standards, but is not a substitute for and does not take precedence over the standards.

This technical release includes two sections and an appendix. Section 1 will help an agency determine whether its environmental contamination meets the definition of probable (i.e., a future outflow of resources will be required to clean up the containment). Section 2 offers guidance in quantifying an agency's liability for cleanup. Appendix I lists key laws and regulations relating to environmental contamination.

SCOPE

This technical release offers guidance based on *Statements of Federal Financial Accounting Standards* (SFFAS), and draws on information from other literature. The applicable federal standards are:

SFFAS No. 6, *Accounting for Property, Plant, and Equipment*

SFFAS No. 5, *Accounting for Liabilities of the Federal Government*

SFFAS No. 6¹ addresses cleanup costs from federal operations known to result in hazardous waste. SFFAS No. 6 provides guidance when cleanup occurs at the end of the useful life of the property, plant, and equipment (PP&E) or at regular intervals (scheduled phase cleanup) during that life.

SFFAS No. 5, *Accounting for Liabilities of the Federal Government*, applies to all environmental liabilities not specifically covered in SFFAS # 6, including cleanup resulting from accidents or where cleanup is an ongoing part of operations².

¹The recognition and measurement provided in SFFAS #6 are subject to the criteria for recognition of liabilities included in SFFAS #5. That is, liabilities shall be recognized when the following conditions are met:

- a past transaction or event has occurred,
- a future outflow or other sacrifice of resources is probable, and
- the future outflow or sacrifice of resources is measurable.

²In the case of cleanup as an ongoing part of operations [i.e., the operation or activity generates hazardous waste that is cleaned up as it is created (e.g., hospitals regularly dispose of hazardous materials)], a liability may not need to be recognized if the need to cleanup and the full cleanup occur in the same reporting period. However, the total cost of cleanup should be recognized in the period the cleanup need arises. Refer to footnote 15 for further information.

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Section 1

Determining "Probable" Environmental Liabilities

Description of Issue

An agency is required to recognize a liability for environmental cleanup costs as a result of past transactions or events when a future outflow or other sacrifice of resources is probable and reasonably estimable.³ Concerns have been raised about *when* costs associated with environmental damage meet the probable and reasonably estimable criteria. Probable is related to whether a future outflow will be required.⁴ This section addresses only the "probable" part of this requirement; reasonably estimable will be addressed in Section 2.

Key Determinants and Positions

Various key factors (tests) must be considered in determining whether a future outflow of resources from a federal agency for environmental cleanup is probable. The factors are:

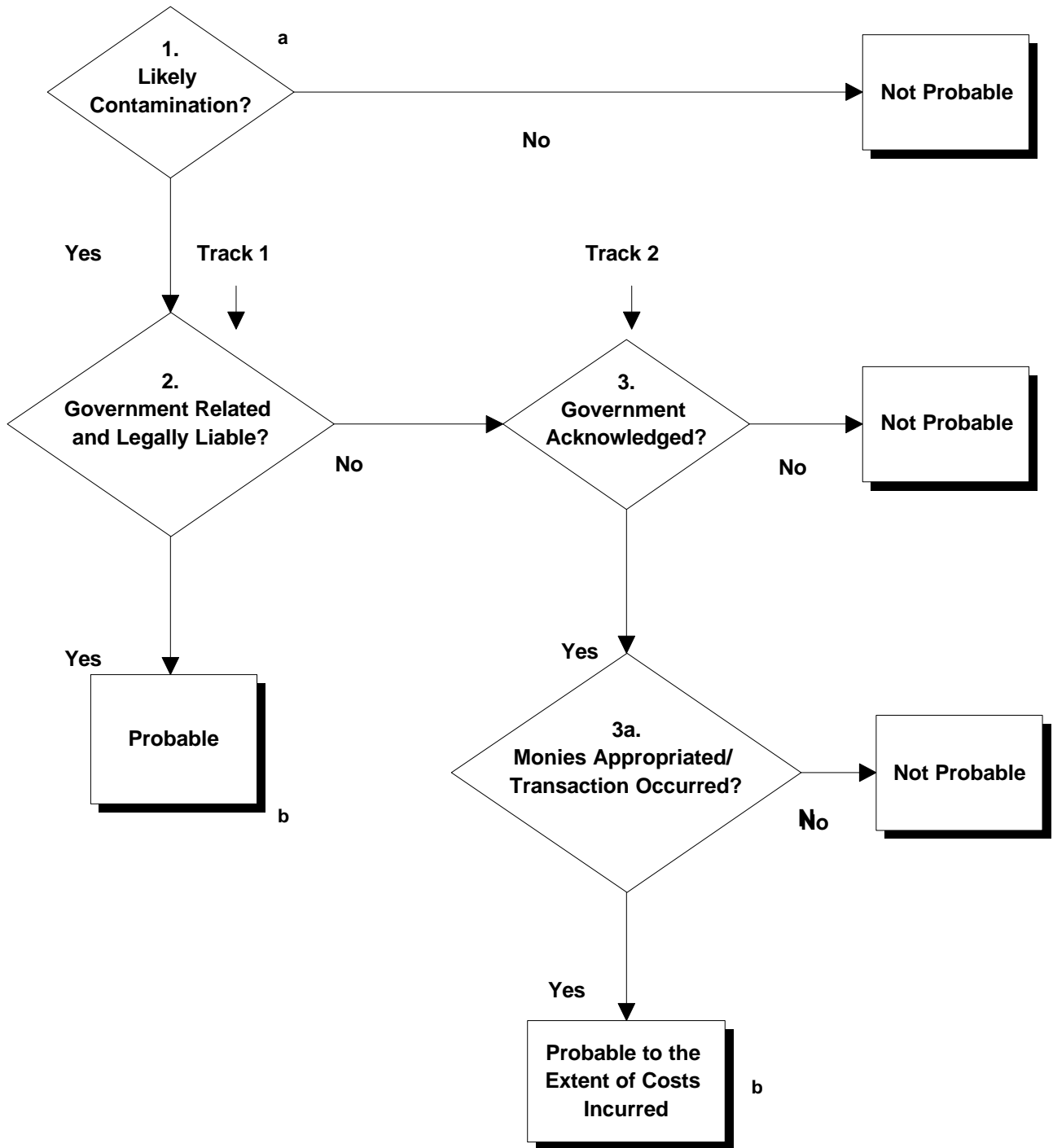
1. Likely Contamination,
2. Government Related and Legally Liable,
3. Government Acknowledged Financial Responsibility,
- 3a. Monies Appropriated/Transaction Occurred, and
4. No Known Remediation Technology Exists.

Diagram 1.1 illustrates the above tests. These tests for probability assume that a past transaction or event has occurred (i.e., past or present operation, contribution and/or transportation of waste), and apply to both active and closed sites. A narrative discussion of each of these tests for probability follows on Diagram 1.1.

³This Release generally discusses "sites" or "contamination" when referring to environmental contamination. However, property, plant and equipment that requires cleanup (because of damaging the environment when being used or at time of disposal) is included in the scope. A further discussion of issues related to PP&E, including recognizing a liability for PP&E already in service, is included in Section 2 under the heading "Guidance for Active Sites."

⁴This Release uses SFFAS No. 5's definition of "probable," which is "more-likely-than-not" (see par. 33 of SFFAS No. 5). This Release applies the contingent liability criteria (i.e., probable, reasonably possible, and remote) from SFFAS No. 5 to all environmental liability estimates, whether or not they meet the criteria (see par. 36 of SFFAS No. 5).

Diagram 1.1: Determination of Probable Environmental Liabilities



^a See discussion on "due care".

^b If *no known technology exists*, then it would be probable to the extent of any required study costs, costs associated with containment, or any other monies obligated or spent. However, given that the actual remediation is not feasible, the actual remediation costs would not meet the probable criteria.

Diagram 1.1 shows that there are two primary tracks for determining whether a federal agency's environmental responsibilities meet the probable criterion. The first track is when contamination is known, is related to federal government operations, and represents a legal liability. The second track is when the federal government knows of contamination, and although the contamination is not government related and the government is not legally liable, the government acknowledges financial responsibility for cleanup. For both tracks, if no known technology exists, then the probability criterion is met only to the extent of likely expenditures (e.g., for study costs and containment). A more detailed discussion of the various components of Diagram 1.1 follows.

1. **Likely Contamination:** If the agency has exercised due care in determining the presence of contamination and as a result, believes it is unlikely that contamination (for which it is responsible) exists, then the probability criterion is not met. However, if the relevant agency is aware of contamination, having used the due care criteria (see below), then the agency must determine whether the contamination is government related and the federal government (i.e., the agency) is legally liable.

Due care refers to a reasonable effort to identify the presence or likely presence of contamination. Due care is considered to be exercised if an agency has effective policies and procedures in place to routinely attempt to identify contamination and forward that information to the responsible agency official. Procedures that are evidence of the exercise of due care may include, but are not limited to, the following:

- review of recorded chain-of-title documents (including restrictions, covenants and any possible liens) and good faith inquiry and investigation into prior uses of the property;
- investigation of aerial photographs *that are available through government agencies* that may reflect prior uses;
- analyses to estimate the existence of uninvestigated sites based on information from known sites;
- inquiry into records *that are available* from federal, state, and/or local jurisdictions that show whether there has been a release or potential release of hazardous substances on the property (and adjacent property, if suspected contaminators exist);
- visual site inspection of any portions of the property where environmental contamination is likely or suspected, and
- investigation of complaints regarding abnormal health conditions.

2. **Government Related and Legally Liable⁵:** As it relates to environmental damage/contamination, government related events are those where a governmental entity either *caused* contamination (i.e., contribution of waste) or is otherwise related to it in such a way that it is legally liable to clean up the contamination. If the agency believes it is more likely than not that it will be legally liable, then the probability criterion is met.⁶
3. **Government Acknowledged Financial Responsibility:** If environmental contamination is not government related, then the agency, under its statutory programmatic authority, must determine whether it is authorized to formally accept financial responsibility for cleanup.⁷ If the government does not accept financial responsibility, then the probability criterion is not met.
- 3a. **Monies Appropriated/Transaction Occurred:** If an agency accepts financial responsibility under No. 3 above,⁸ then the agency determines the extent of probability based on appropriation or authorization legislation and whether a transaction has occurred causing another party to expect payment (e.g., contractor has performed cleanup of a site). For example, if the federal government has acknowledged responsibility for cleaning up a site, the cost of which is at \$10 million, and \$2 million has been appropriated but only \$1 million in services have been rendered, probable is only met to the extent of \$1 million. In the case of government acknowledged events, both conditions (i.e., appropriations or authorization and transaction executed) must exist for the probability criterion to be met.
4. **No Known Remediation Technology Exists:** In the case of a government related event, where there is no known technology to clean up a particular site, then known costs, for which the entity is responsible, such as a remedial investigation/feasibility study (RI/FS) and/or costs to contain the contamination, meet the probability test. With no known remediation technology, actual remediation is not feasible and therefore the outflow of resources for remediation is not probable.

⁵**Legally liable** is defined, generally, as any duty, obligation or responsibility established by a statute, regulation, or court decision, or where the agency has agreed, in an interagency agreement, settlement agreement, or similar legally binding document, to assume responsibility for cleanup costs. Legal liability should be determined in consultation with the entity's legal counsel. [See American Bar Association's (ABA) Statement of Policy Regarding Lawyers Responses to Auditors' Request for Information (December 1975). Also see American Institute of Certified Public Accountants (AICPA) Professional Standards, Auditing Standards (AU) Section 337C -- source SAS No. 12.]

⁶Federal entities should consider the Environmental Protection Agency's (EPA) National Priorities List [which identifies "potentially responsible parties" (PRP)] when determining probability.

⁷"The Federal government has broad responsibility to provide for the public's general welfare. The Federal government has established programs to fulfill many of the general needs of the public and often assumes responsibilities for which it has no prior legal obligation." Statement of Federal Financial Accounting Standards No. 5, ¶ 30.

⁸ This Release does not propose a position regarding environmental contamination caused by natural disasters which may become the responsibility of the Federal Emergency Management Agency's (FEMA).

SECTION 2

Determining "Reasonably Estimable" Environmental Liabilities

Description of Issue

An agency is required to recognize a liability for environmental cleanup costs resulting from past transactions or events when a future outflow or other sacrifice of resources is probable and reasonably estimable. Concerns have been raised about *when* costs associated with environmental damage meets the probable and reasonably estimable criteria. Reasonably estimable relates to the ability to reliably quantify in monetary terms the outflow of resources that will be required. This section addresses only the "reasonably estimable" part of this requirement; probable was addressed in Section 1.⁹

Key Determinants and Positions

Various key factors (tests) should be considered in determining whether future outflows of resources can be reasonably estimated. The factors are:

1. Completion of a Remedial Investigation/Feasibility Study (RI/FS)¹⁰ or other Study,
2. Experience with Similar Site and/or Conditions, and
3. Availability of Remediation Technology.

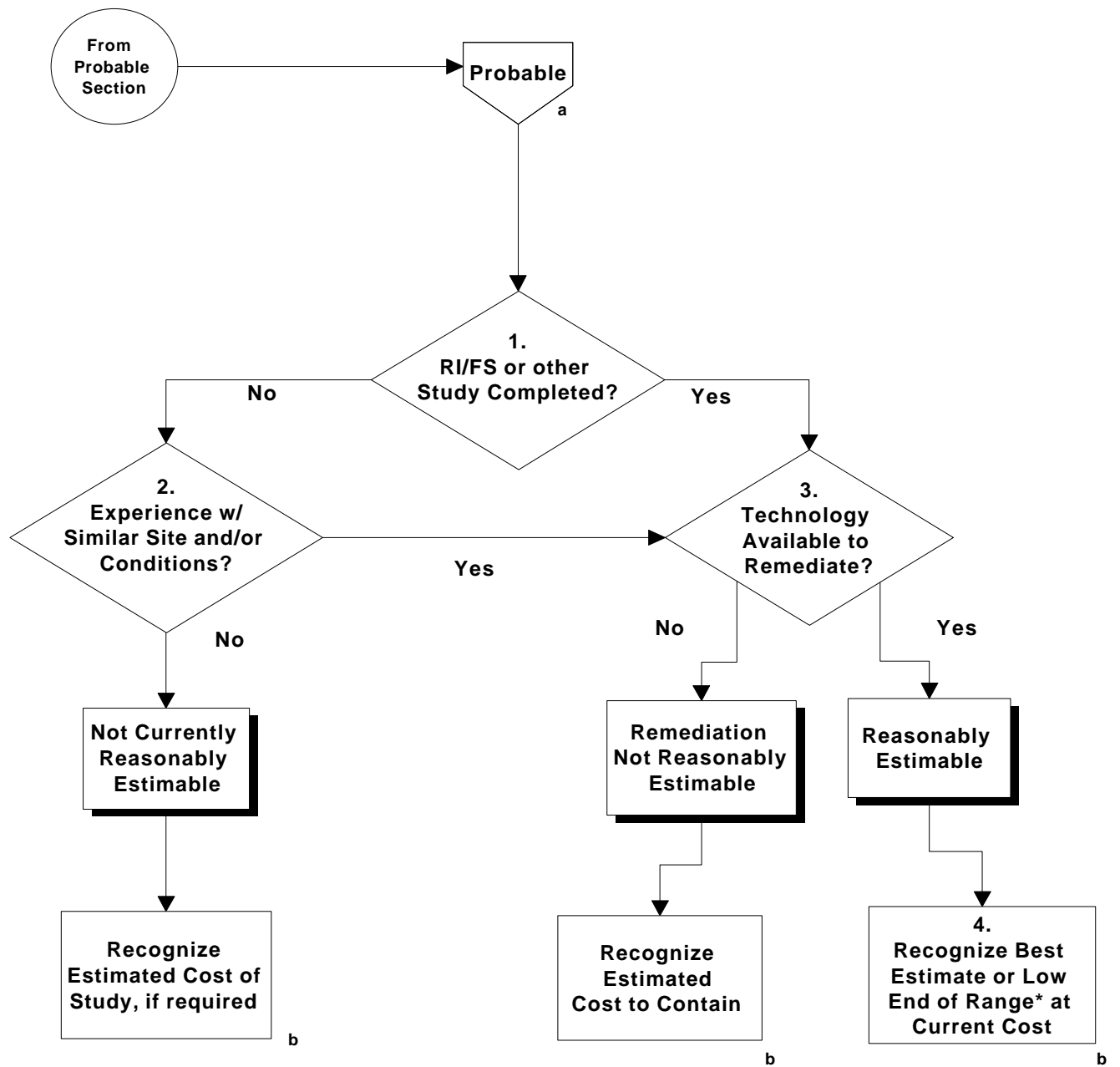
These tests for reasonably estimable are applied after a transaction or event has occurred that meets the definition of "probable" as discussed in Section 1; tests apply to both active and closed sites. The analysis should consider all significant sites, with the information rolled up into an entitywide estimate. Cost estimates should be based on current technology. Diagram 2.1 on page 7 illustrates the application of these tests. A discussion of each of the three tests follows Diagram 2.1. The discussion concludes with issues related to quantification of the estimate and guidance for active sites. Overall, it must be emphasized that every effort should be made to develop an estimate.

⁹ Disclosure requirements when the criteria for reasonably estimable are not met are as follows:

- the nature of the environmental damage and
- an estimate of the possible liability, an estimate of the range of the possible liability, or a statement that such an estimate cannot be made.

¹⁰ A remedial investigation/feasibility study (RI/FS) is a comprehensive environmental data collection and site characterization study (RI) that evaluates alternative cleanup actions and recommends one (FS).

Diagram 2.1: Determination and Quantification of Reasonably Estimable Environmental Liabilities



*Low end of range could be containment, if containment is chosen as the option to be pursued.

a Probable refers to track 1 (government related) which is found in Section 1. Track 2 (government acknowledged) is not applicable.

b With all tracks, see SFFAS #6 par. 107-111 and SFFAS #5 par. 40-42 for disclosure requirements.

Diagram 2.1 begins with the assumption that costs associated with environmental damage has already met the test for probable. This is a direct continuation of the left-side track of Diagram 1.1 on the definition of probable (i.e., the agency has met probable under government related and is legally liable; see Section 1). As it relates to the "probable" second track (i.e., government acknowledged), probable is only met to the extent that monies have been appropriated or authorized (through authorization legislation) and costs have been incurred (e.g., services rendered). In these situations, a definitive dollar figure has already been determined and an estimate is not required. Therefore, the following discussion refers to determining whether something is "reasonably estimable" only as it relates to government related and legally liable.

1. **Completion of RI/FS or other Study:** The first test in determining whether costs are reasonably estimable is to ascertain whether there is a completed study upon which to base an estimate. For example, if a remedial investigation/ feasibility study (RI/FS) has been completed for a particular site, the RI/FS would form the basis upon which to begin estimating the liability.

The fact that an agency does not have a *departmentwide* comprehensive study completed does not exempt an agency from making its best effort to estimate a liability for financial statement purposes, or for recognizing a liability for that portion of its obligation that can be estimated.

If the results of the study indicate that no contamination exists, then probability is not met and the decision process of Diagram 2.1 should be considered complete.

2. **Experience With Similar Site and/or Conditions:** If no study has been completed, the next test is to determine whether a site appears to be similar to any other site or condition where experience has been gained through either a completed study or actual remediation. Similar sites or conditions could be related to other federal entities or private sector corporations. A "site" is defined as a physical place where contamination has occurred. A "location" can be composed of many sites; a site can contain many "conditions." It may be practical for an agency to combine similar conditions or sites into one large site or location.

If there is a similar site or condition with experience gained (through actual cleanup and/or a completed study to compare), the estimate for recognizing a liability for a site could be based on the similar experience or conditions. In addition, the estimated cost of a future study (if required) should be recognized. Future studies could result in improved estimates.

If there is no comparable site and/or condition, remediation costs for a site would not be considered reasonably estimable at that time, but the agency would recognize the anticipated cost of conducting a future study, if required, plus any other identifiable costs.

3. **Availability of Remediation Technology:** Assuming a study has been completed, or an agency or other entity has experience with a similar site and/or condition as noted above, the next test is whether there is technology available to remediate a site. If no remediation technology exists, then remediation costs would not be reasonably estimable, but the agency would be required to recognize the costs to contain the contamination and any other relevant costs, such as costs of future studies.

If technology is available, then remediation costs are reasonably estimable, and the agency would

recognize the best estimate at current cost. If no amount within a range of estimates is a better estimate than any other amount, the minimum amount in the range would be recognized. If the estimate is based on similar site criteria, the agency would also recognize the anticipated cost of its own RI/FS or other study, if required.

In certain instances, the RI/FS or other study may conclude that even though technology *does* exist to remediate, containment should be considered as one of the options by the agency. If the agency has yet to make a decision and they may in fact choose containment rather than remediation, and assuming containment is not precluded by other involved parties (i.e., by EPA, individual states and/or local jurisdictions), the agency would consider the estimated cost of containment when calculating the estimated costs to be recognized or disclosed. The agency would calculate an amount to be recognized based on the type and length of containment required.¹¹

If management has not determined what remedial action should be taken for a contaminated *active* site, the cost of containment at the end of the facility's useful life, plus the cost of a study, if not yet done, should be considered as the low end of the range of future estimated cleanup costs.

4. **Quantification of the Estimate:** According to paragraph 39 of the SFFAS No. 5 on contingent liabilities, the estimated liability may be a specific amount or a range of amounts.¹² If some amount within the range is a better estimate than any other amount within the range, that amount is recognized. If no amount within the range is a better estimate than any other amount, the minimum amount in the range is recognized. According to SFFAS No. 6, ¶ 95, estimated costs should be based on the cleanup plan, assuming current technology and current cost.

Changes in environmental liability estimates related to PP&E should be accounted for in accordance with SFFAS No. 6. For general PP&E, SFFAS No. 6 requires that the portion of the re-estimate related to current and prior periods be recognized as an expense in the period of the change. For stewardship PP&E, SFFAS No. 6 requires that the change in estimate be expensed for the incremental costs identified in the reestimate and the liability adjusted in the period of the change.

Where an agency is one of several potentially responsible parties (PRP's) under CERCLA and management has determined that more likely than not the agency is legally liable, the agency should include an estimated liability for its:

- (1) allocable share of the liability for a specific site, and

¹¹RCRA (Resource Conservation and Recovery Act) regulations require owners of hazardous waste disposal facilities to implement post-closure maintenance and monitoring activities for a minimum of 30 years. When developing estimates of these operation and maintenance (O&M) costs, EPA generally assumes that O&M activities will be required for 30 years. In most instances, containment costs should be determined on the basis of a minimum of 30 years. It would be expected that in the case of nuclear contamination, different tri-party agreements, technical problems, or other circumstances may lead to the use of a substantially longer time frame than for typical RCRA or CERCLA (Comprehensive Environmental Response Compensation and Liability Act of 1980) sites.

¹²This Release uses SFFAS No. 5's definition of "probable," which is "more-likely-than-not" (see par. 33 of SFFAS No. 5). This Release applies the contingent liability criteria (i.e., probable, reasonably possible, and remote) from SFFAS No. 5 to all environmental liability estimates, whether or not they meet the criteria (see par. 36 of SFFAS No. 5).

(2) share of amounts related to the site that will not be paid by other PRP's.¹³

If an agency shares responsibility with nongovernmental PRP's for a government related event, the agency should recognize the share that management believes it is more likely than not the agency is legally liable for.¹⁴ Where the federal government shares responsibility with nongovernmental PRP's and agency management has decided to accept the nongovernmental PRP's share of the responsibility for the damage (i.e., a government acknowledged event), the agency would *also* recognize a liability for the PRP's share once the criteria of appropriation or authorization legislation and a transaction have occurred, causing another party to expect payment (e.g., contractor has performed site cleanup).

¹³ AICPA Statement of Position (SOP) 96-1, *Environmental Remediation Liabilities*, page 43 par. 6.2.

¹⁴ If management determines that an agency should assume responsibility for a portion of another PRP's share of the liability, the agency may recognize a receivable from the other PRP when the federal entity establishes a claim to cash or other assets against the other PRP based on the related legal provisions (i.e., a legal instrument, such as a settlement agreement, or other objective, verifiable information). Losses on receivables should be recognized when it is more likely than not that the receivables will not be collected in total.

Guidance for Active Sites

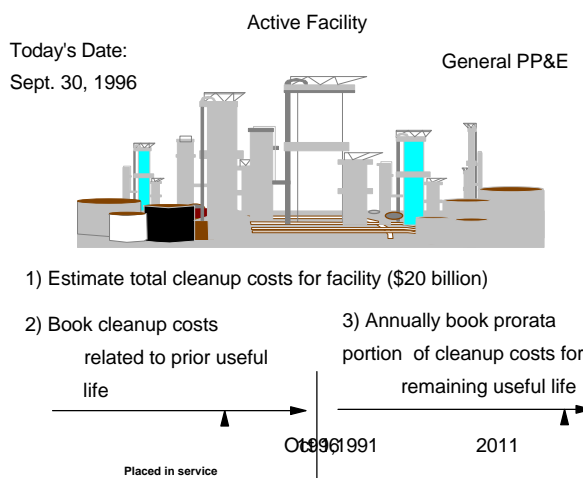
Thus far, this technical release has dealt with costs for *past* environmental contamination of property, plant, and equipment (PP&E) related to active and closed sites. In addition, SFFAS No. 6 outlines accounting treatment for *future* environmental contamination of PP&E at active sites. The following shows how environmental cleanup costs¹⁵ for active sites should be recognized for general and stewardship PP&E under SFFAS No. 6.

General PP&E

There are two implementation methods for general PP&E in service at the effective date of the standard. Under the first method, the agency would estimate the total cleanup costs (based on current cost to perform the cleanup¹⁶) that will be required at the end of the PP&E's useful life. The agency would recognize the estimated cost as a prior period adjustment for the portion of the total estimated cleanup costs related to that portion of the *PP&E's useful life that has already expired*.

To illustrate, assume implementation of SFFAS No. 6 on October 1, 1996. Using the illustration to the right, and assuming a facility was placed in service at the beginning of fiscal year 1992 with a 20-year useful life, the agency would first estimate the total costs (based on current cost) required to clean up the contaminated facility at the presumed plant closure at the end of fiscal year 2011 (\$20 billion). From that estimate (as of October 1, 1996), the amount that relates to that portion of the PP&E's useful life that has already expired (4/20 of \$20 billion, or \$4 billion) would be charged to net position and the fiscal year 1996 prorata portion would be charged to expense.

Beginning with fiscal year 1997, the agency would annually recognize a prorata portion of the estimated total cleanup costs based on the remaining useful life of the subject PP&E. In our example, for fiscal year 1997, for this plant (with an estimated remaining useful life of 15 years), the agency would recognize 1/15 of the total estimated remaining cleanup cost of \$15 billion, or \$1 billion. The probable criterion was met under Diagram 1.1 once the PP&E was placed in service. The reasonably estimable criterion was met with the agency's development of an overall estimate of total cleanup costs using the process indicated in Diagram 2.1. Consequently, each years' allocation of cleanup costs is both probable and reasonably estimable, thus requiring the agency to recognize a liability. The allocation method used for cleanup costs, as described above, is similar to depreciation of general PP&E.



¹⁵Costs referred to in this section are for decontamination and decommissioning (D&D) only, not operating costs. D&D costs are those incurred after plants or equipment become inactive and require cleanup. Operating costs are period costs that flow through the *Statement of Operations and Changes in Net Position*. A liability is not recognized for operating costs.

¹⁶Current cost should be based on existing laws, technology and management plans (SFFAS No.6, paragraph 188).

Changes in estimates of cleanup costs should be accounted for in accordance with the SFFAS No. 6, which requires that the cumulative effect of changes in total estimated cleanup costs related to current and past operations be recognized as expense, and the liability adjusted in the period of the change in estimate.

SFFAS No. 6 allows a second method for recognizing cleanup cost related to general PP&E in service at the effective date of the standard. The alternative method provides that "if costs are not intended to be recovered primarily through user charges, management may elect to recognize the estimated total [ultimate] cleanup cost as a liability upon implementation of the standard."¹⁷

For general PP&E placed in service after the effective date of the standard, the agency should estimate the total cleanup costs¹⁸ related to the PP&E and recognize annually a prorata portion of the costs over the life of the asset. Expense recognition shall begin on the date that the PP&E is placed into service.

Because contaminate land does not have a useful life and is not depreciated, it should be treated the same as the facility that is located on the land. For land contaminated in the past, a liability should be recognized for the total estimated cleanup costs. For land expected to be contaminated in the future due to ongoing operations, a portion of estimated total cleanup costs shall be recognized as expense during each period that the associated general PP&E is in operation. If no facility is associated with the land, the land should be treated as stewardship PP&E. SFFAS No. 6 provides guidance for stewardship PP&E (see the following paragraph for a brief summary of stewardship PP&E).

Stewardship PP&E

Stewardship PP&E includes federal mission PP&E¹⁹, heritage assets, and stewardship land. For stewardship PP&E *already in service*, according to SFFAS No. 6, on the day the standard is adopted or upon early implementation, the agency would charge net position through a prior period adjustment and recognize a liability for the full amount of the estimated ultimate cleanup costs. For *new* stewardship PP&E, the agency would recognize an expense and a liability for the total amount of estimated ultimate cleanup costs when the PP&E is placed in service. As with general PP&E, the probable criteria would be determined under Diagram 1.1 at the time the standard is adopted or new PP&E is placed in service. Likewise, the reasonably estimable criteria for the total ultimate cleanup costs would be determined based on Diagram 2.1. However, unlike general PP&E, stewardship PP&E is fully expensed once acquisition costs are incurred. SFFAS No. 6 calls for the entire ultimate cleanup costs to be expensed when the PP&E is placed in service.

¹⁷SFFAS No. 6 paragraph 104

¹⁸According to SFFAS #6 paragraph 95 the estimate shall contemplate:

- the cleanup plan, including
 - level of restoration to be performed,
 - current legal or regulatory requirements, and
 - current technology; and
- current cost which is the amount that would be paid if all equipment, facilities, and services included in the estimate were acquired during the current period.

¹⁹The FASAB is currently developing an exposure draft that proposes to change the term "federal mission PP&E" to "national defense PP&E" and to alter the definition.

Appendix I - Relevant Laws

This appendix lists some of the laws that relate to environmental cleanup. It is not intended to be a comprehensive list of all pertinent laws. Federal agencies should check with their Office of General Counsel to determine which laws are applicable to their agency.

I. Principal Environmental Laws to Which Federal Facilities Are Subject

- A. Comprehensive Environmental Response Compensation and Liability Act of 1980 (CERCLA, or Superfund), and subsequent amendments
 - 1. Administered by EPA
 - 2. Established a program to identify sites (National Priorities List)
 - a. Typically abandoned or inactive sites
 - b. Can be applied to sites still in operation
 - 3. Set up trust fund to cover costs (with attempts to recover)
 - 4. Detailed standards for remediation and settlement provisions and authorized criminal sanctions
 - 5. Entities may have "joint and several" liability for cleanup
- B. Resource Conservation and Recovery Act (RCRA)
 - 1. Permits issued by EPA for facilities used or being used to manage hazardous waste (includes generating, treatment, storage, and disposal)
 - 2. Covers both closed and active facilities
- C. Clean Air Act
- D. Clean Water Act

II. Other Environmental Laws

- A. Safe Drinking Water Act
- B. Toxic Substances Control Act
- C. Federal Insecticide, Fungicide, and Rodenticide Act
- D. Pollution Prevention Act 1990
- E. Federal Facilities Compliance Act
- F. Nuclear Regulatory Act and its amendments
- G. Emergency Planning and Community Right-to-Know Act

IV. State laws

- A. For federal cleanup activities, state standards can apply, which are at least as stringent as federal laws

V. Foreign Laws

- A. As applicable

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